PALOMA PETROLEUM LTD.

ANNUAL REPORT 1977

DIRECTORS:
Walter J. Adams, Edmonton, Alberta
G. Clarence Elliott, Winnipeg, Manitoba
W. Roy Jennings, Calgary, Alberta
D. M. Laurence, Calgary, Alberta
William H. Molle, Toronto, Ontario
John E. Stobart, Calgary, Alberta

OFFICERS:
Walter J. Adams, Chairman of the Board
D. M. Laurence,
Deputy Chairman of the Board
John E. Stobart, President
Norman F. Talbot, Secretary-Treasurer

HEAD OFFICE:
1150 Guinness House
727 - 7 Avenue S.W.
Calgary, Alberta
T2P 0Z7

TRANSFER AGENT
AND REGISTRAR:
Montreal Trust Company
Calgary, Vancouver, Toronto, Montreal

LEGAL COUNSEL:
McLaws & Company
Calgary, Alberta

AUDITORS:
Peat, Marwick, Mitchell & Co.
Calgary, Alberta

BANKERS:
The Toronto-Dominion Bank
Main Branch, Calgary

SUBSIDIARY COMPANIES:
Compass Investments of Alberta Limited
Compass Resources Ltd.
Conquest Oil & Mining Ltd.
Conquest Resources, Inc.
Grenville Exploration Limited
Grizzly Petroleum Limited
Paloma Petroleums, Inc.

Board of Directors from left to right: W. Roy Jennings, D. M. Laurence, William H. Molle, John E. Stobart, Walter J. Adams and G. Clarence Elliott

CORPORATE HIGHLIGHTS

FINANCIAL	1977	1976
Gross income	**$ 7,730,802**	$ 6,567,973
Cash flow from operations	**2,662,140**	1,501,157
Per share	**.63**	.36
Net earnings before extraordinary items	**728,419**	284,065
Per share	**.17**	.07
Net earnings	**1,037,097**	433,565
Per share	**.24**	.10
OPERATIONS		
Natural Gas Sales (Mcf)	**4,004,541**	3,719,000
Daily average	**10,971**	10,189
Crude oil and condensate production (barrels)	**166,758**	151,745
Daily average	**457**	416
Proven reserves:		
Natural gas (Mcf)	**78,215,000**	93,172,000
Crude oil and condensate (barrels)	**1,940,951**	1,975,347
Probable additional reserves:		
Natural gas (Mcf)	**19,073,000**	8,168,000
Crude oil and condensate (barrels)	**350,564**	51,377
Land holdings including royalty interests:		
Gross acres	**867,383**	4,468,105
Net acres	**211,925**	302,120

ANNUAL MEETING

The Annual General Meeting of the Shareholders will be held on May 17, 1978, in Salon E, Holiday Inn, 708 - 8th Avenue S.W., Calgary, Alberta, at 2:00 p.m.

REPORT OF THE DIRECTORS TO THE SHAREHOLDERS

The Company's revenues from oil and gas operations increased 45% from $3,048,384. in 1976 to $4,405,186. in 1977. Revenues from hotel operations decreased to $3,236,557. from $3,422,570. for the previous year due primarily to the sale of two hotels at Swan Hills and Drayton Valley, Alberta. The sale of hotels is consistent with the Company's plan to concentrate on oil and gas activities.

An independent engineering evaluation dated January 1, 1978 of the oil and gas properties of Paloma and its subsidiaries, Compass Investments of Alberta Ltd., Conquest Oil & Mining Ltd. and Compass Resources Ltd. indicated that the present value of proved reserves, discounted at 12%, was $55,958,000. and of proved and probable additional reserves was $65,602,000. Undeveloped lands were valued at $1,993,000. Paloma owns, directly or indirectly, over 90% of the above subsidiaries. We are gratified by the steady growth in the value of the Company's assets.

Our 1977 exploration program was highlighted by successful drilling at Stanmore, Alberta where we have 8 of our 11 gas wells on stream, and in Louisiana where we are partners in an important discovery of oil, gas and gas condensate on a 22,000 acre land spread near Cotton Valley in Webster Parish.

Other gas discoveries made at Rowley, Wildunn, Halliday, Haven and Hercules, Alberta are shut-in awaiting markets. Two additional gas wells were drilled at Jarrow, Alberta and were put on production during the year. Our oil discovery, of early 1977, at Leduc-Woodbend has been producing steadily. The Company participated in 40 wells in 1977 which resulted in 27 gas wells, 1 oil well and 12 dry holes. Our average interest in the wells drilled was 26% and we were the operator for just under half of the wells drilled.

We continue to concentrate on drilling in Alberta and favor those lands where gas markets are readily available. Although we have a number of shut-in wells, we estimate that 89% of the Company's reserves are under contract.

Natural gas sales were 4,004,541 MCF which was an 8% increase over 1976, in spite of a 27% decline in gas sales from our Dunvegan field. The numerous transmission pipeline failures which affected sales from Dunvegan are now believed to be rectified and we look forward to improved revenues from that field during 1978. Our greatest source of production revenue continues to be the Dunvegan Gas Unit; however, as additional production is put on stream in other fields such as Jarrow and Stanmore, the Dunvegan contribution to our revenue will gradually assume less significance. Gas sales from areas, other than Dunvegan, increased by 56% over the level of the previous year, primarily due to our successful efforts at Stanmore, Alberta. Crude oil and condensate production increased 10% to 166,758 barrels.

The current wellhead price of Alberta gas is $1.52/MCF and for oil it is $11.75/bbl. Price increases of $1.00/bbl. are scheduled for July 1, 1978 and January 1, 1979 with equivalent gas price increases expected on a relative heating value basis.

The efforts of our employees have been greatly appreciated during the past year and we are confident that 1978 will be another year of significant growth.

On Behalf of the Board of Directors

John E. Stobart

J. E. Stobart, President

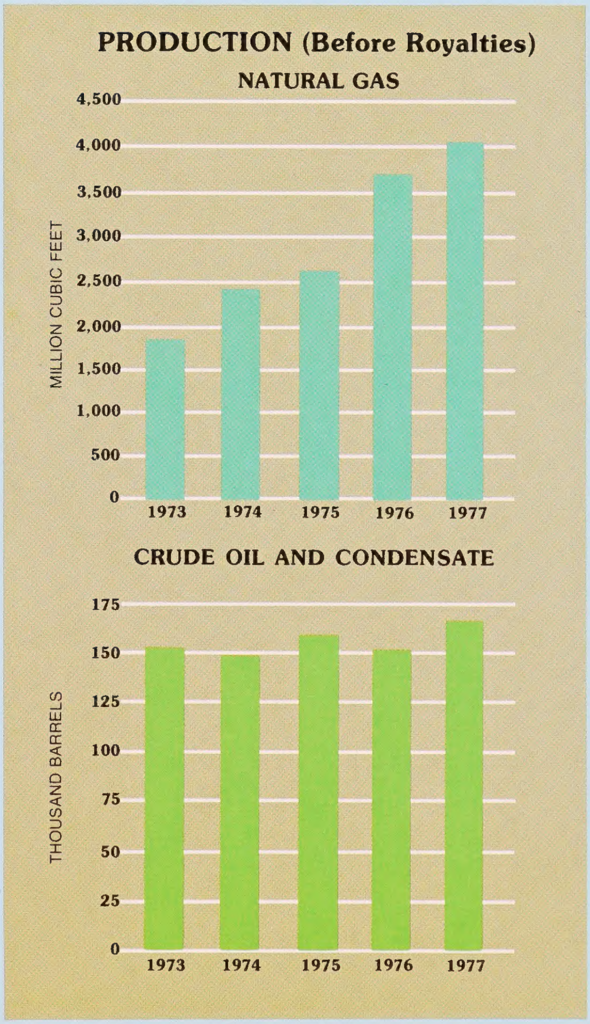
March 7, 1978
Calgary, Alberta

REVIEW OF 1977 OPERATIONS

DRILLING ACTIVITY

Paloma Petroleum Ltd. and its subsidiaries participated in the drilling of 21 exploratory and 19 development wells during the year. The Company's drilling activity resulted in 27 gas discoveries and a very successful Leduc-Woodbend oil well. Paloma's net interest in wells drilled is as follows:

	Gross	Net
Exploratory	21	5.4
Productive	14	4.2
Dry	7	1.2
Development	19	5.1
Productive	14	4.2
Dry	5	.9



PRODUCTION

NATURAL GAS

Overall natural gas sales increased by 8% over the prior year in spite of a 27% decline in gas sales from our Dunvegan field. The numerous transmission pipeline failures affecting the 1977 sales from Dunvegan are now believed to be rectified and we look forward to improved revenue from that field during 1978. Gas sales from areas, other than Dunvegan, increased by 56% over 1976 levels, primarily due to our successful efforts at Stanmore, Alberta.

OIL AND CONDENSATE

Crude oil and condensate production increased 10% to 166,758 barrels from the 1976 level of 151,745 barrels as a result of our Leduc-Woodbend D-3 oil well which is producing 170 barrels per day.

RESERVES (Before Deduction of Royalties)

DECEMBER, 1977

	Proved	Probable	Total
CRUDE OIL AND CONDENSATE (Bbls.)			
Province of Alberta	1,534,576	350,564	1,885,140
Province of Saskatchewan	406,375	—	406,375
TOTAL	1,940,951	350,564	2,291,515
NATURAL GAS (Mcf)			
Province of Alberta:			
Peace River Area	45,453,000	12,306,000	57,759,000
Other	32,762,000	6,767,000	39,529,000
TOTAL	78,215,000	19,073,000	97,288,000

The Company's total proved and probable gas reserves decreased to 97,288 million cubic feet from the 1976 level of 101,340 million cubic feet. The major changes in reserves are attributable to the Peace River area, in Alberta, where our consulting engineers have reclassified some of the Dunvegan reserves to probable from the proved category and have made significant downward revisions to the Belloy reserves as a result of production performance. Our successful drilling program at Stanmore, Alberta added 8,113 million cubic feet to our proved reserves.

The excess gas supply situation, which became evident during the latter half of 1976, worsened through 1977 as record drilling activity increased the surplus of gas. High level government and industry discussions are currently taking place concerning means of alleviating the situation with some form of accelerated deliveries to the United States appearing to be the most likely solution to the problem. We anticipate that most shut-in gas reserves will not have a market outlet for two years. With respect to Paloma's reserves, 89% are currently under contract.

PRICES AND MARKETS

The current average wellhead price for Alberta gas is $1.52/MCF and $11.75/bbl. oil. Price increases of $1.00/bbl. are scheduled for July 1, 1978 and January 1, 1979. Equivalent gas price increases are expected on a relative heating value basis.

LAND HOLDINGS

December 31, 1977

	Total	
	Gross Acres	Net Acres
Alberta	718,170	167,334
British Columbia	1,282	738
Saskatchewan	9,049	1,665
U.S.A.	138,882	42,188
	867,383	211,925

CANADA

Dunvegan

Gas and condensate sales from the Dunvegan Gas Unit, in the Peace River area of Alberta, continues to be our greatest source of revenue. However, as other fields come on stream, Dunvegan's contribution to our revenue will gradually assume less significance. Paloma sold 1,563 MMCF of gas and 12,503 barrels of condensate from the Dunvegan Gas Unit in 1977. Pipeline problems, which had curtailed production for over one year, were corrected by mid-1977. Alberta and Southern Gas Co. Ltd. (A & S), the gas purchaser, has not been able to take the minimum Daily Contract Quantity, 159 MMCFD, because of lack of market and we therefore expect to receive a payment in lieu of gas not taken during the July 1, 1977 to June 30, 1978 contract year. A & S has five years to make up gas paid for but not taken.

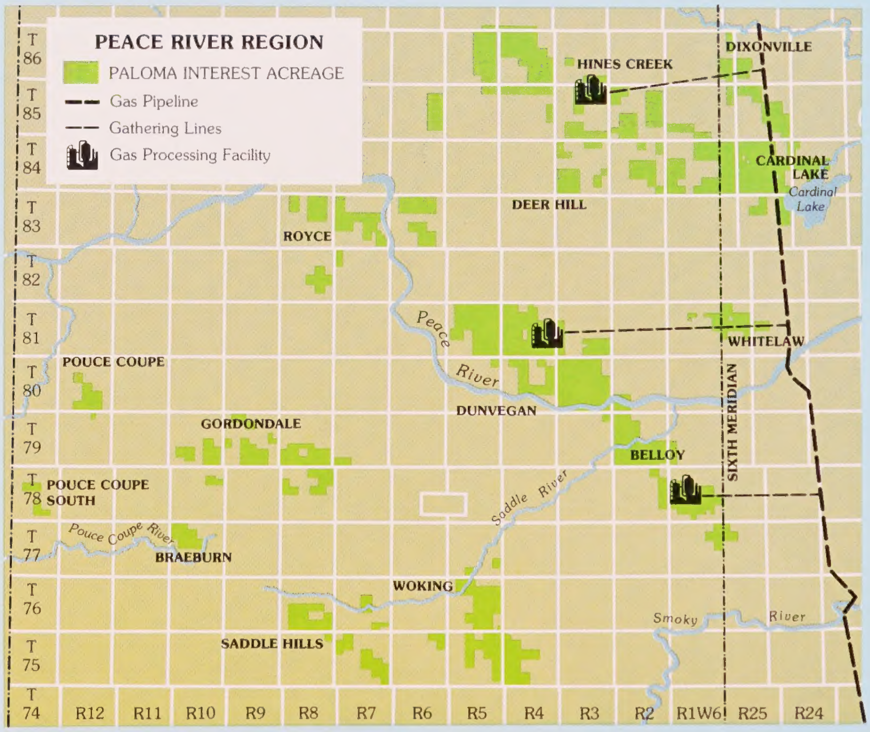
The installation of new facilities, work-overs of existing wells and the tie-in of additional wells is continually being done to upgrade and maintain the producing capability of this field. Paloma has a 4.3% working interest in the Dunvegan Gas Unit.

Belloy

Paloma has a 21.875% interest in most of the Belloy gas field in the Peace River region. This field produced at an average daily rate of 6.7 MMCF during 1977. Our share of sales from Belloy was 494 MMCF.

Peace River Area

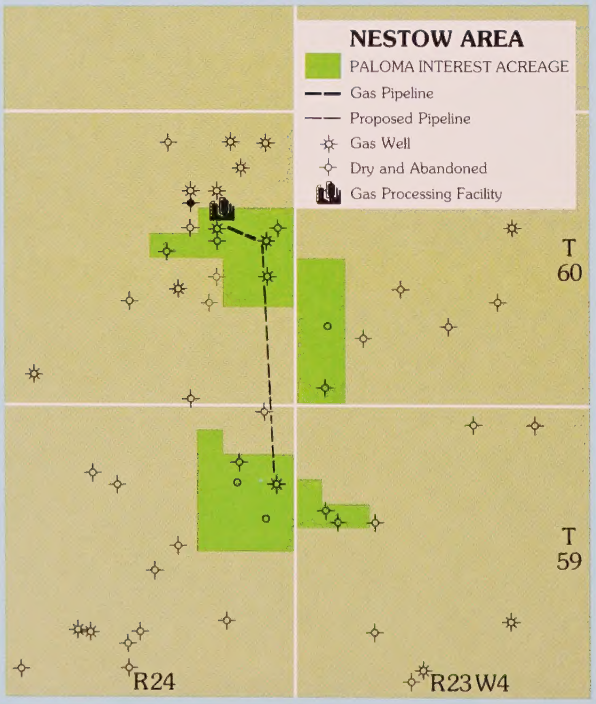
The Company has interests in 390,347 gross acres or 20,915 net acres, over 80% of which can still be considered undeveloped. There is considerable exploration potential in the area but our activities have been at a low level because of the lack of gas markets. We continue to produce at Hines Creek at the rate of 4.8 MMCFD where our net



interest is 8.33%. At Dixonville, there are three shut-in gas wells not on stream. The potential is approximately 4 MMCFD with the Company's interest being 8.33%. At Cardinal Lake, we have a 4.77% interest in two shut-in gas wells.

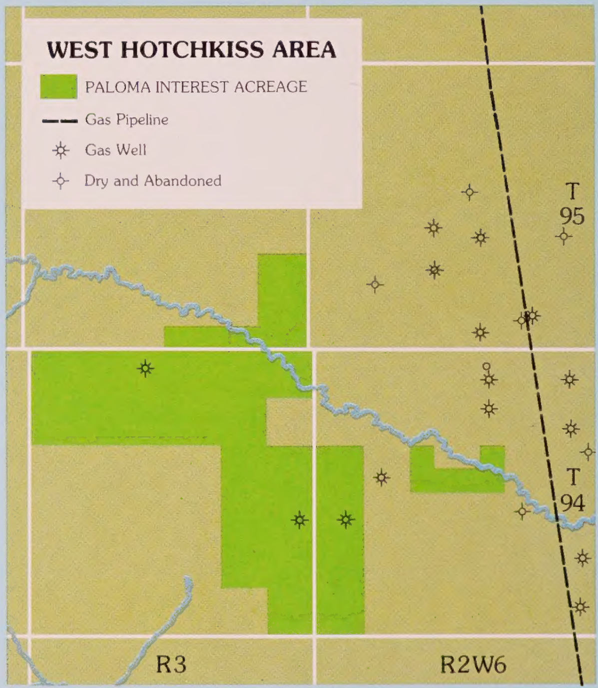
Nestow

The Nestow gas field is 40 miles north of Edmonton. The Company has two wells currently producing 2.5 MMCFD (1.0 MMCFD net to the Company). During 1977 we conducted seismic surveys and drilled two wells, one of which has a potential of 750 MCFD and is waiting to be tied in; while the other, a marginal discovery, is currently suspended. Three additional wells are scheduled for 1978. We are aiming at a producing capacity of up to 5 MMCFD which is the contract maximum with TransCanada PipeLines Limited. At Nestow, the Company holds 7,840 gross acres; 3,057 net acres.



West Hotchkiss

West Hotchkiss is located 140 miles north of Grande Prairie, Alberta. The Company participated in a successful gas well in 1977 and we now have an interest in three shut-in gas wells and 16,690 gross acres (2,532 net acres) located five miles west of a major gas trunk line. This project has exciting gas potential, with the industry showing considerable interest in the area, and we expect to do further drilling when a gas market is available.



Woodbend

Paloma made a D-3 oil discovery just outside the northeast producing limits of the Leduc-Woodbend field. The discovery well was based on seismic information and was directionally drilled under the North Saskatchewan River, within an 80 acre spacing unit. We are producing 170 barrels of oil per day from the D-3 zone and have indicated hydrocarbons in the D-2 zone which will be produced at some future date. Paloma's interest is 71.3%.

Jarrow

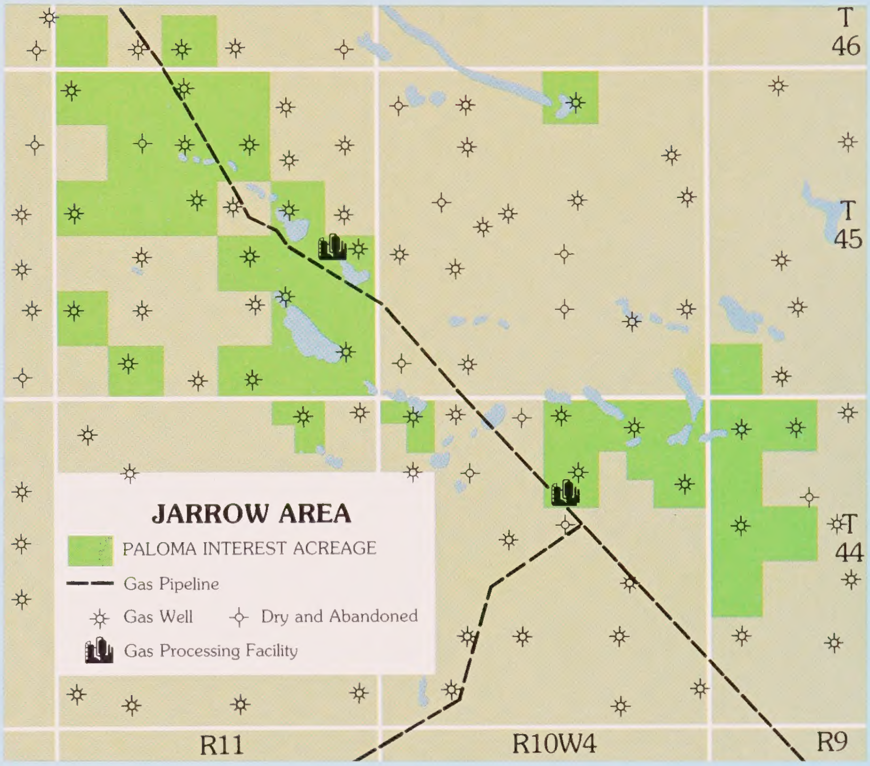
We participated in the drilling of two additional gas wells in 1977 where the Company now has interests in 25 gas wells in the Jarrow field in east-central Alberta. The Company's production in 1977 was 737 MMCF and our net daily production in 1978 is expected to average 2.25 MMCFD. Our Jarrow holdings consist of 23,840 acres gross; 7,762 acres net.

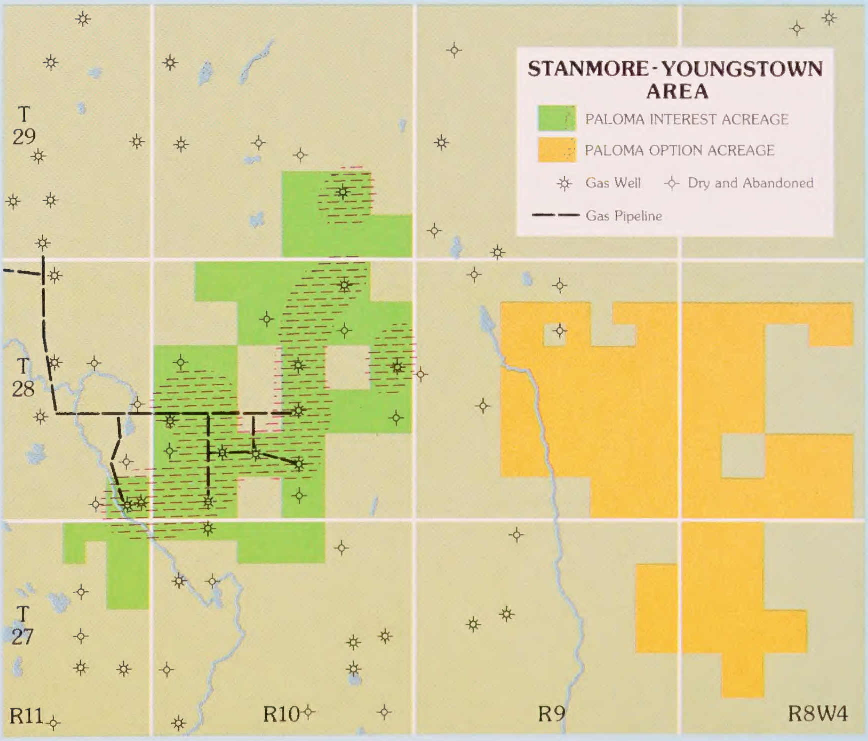
Stanmore

The Company has acquired an interest in 22,880 gross acres (7,099 net acres) through farmout drilling and lease purchase in the Stanmore area located 150 miles east-northeast of Calgary. Drilling, based on Company operated seismic surveys, has resulted in 11 gas wells and there are a number of additional locations which will be drilled when gas markets are available. There are currently eight gas wells producing 7 MMCFD sales gas through a non-operated gas plant in the area. In 1978 we plan to increase the capacity of our pipeline gathering system by pipeline looping and to add three wells to the system.

Youngstown

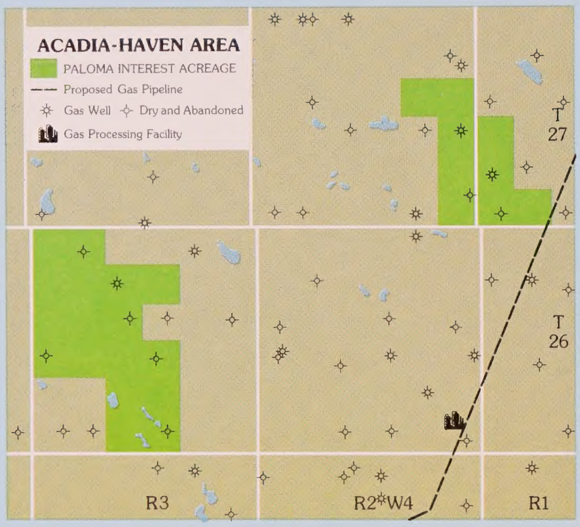
The Company has taken a farmout on a 40 section block lying 10 miles east of our Stanmore field where the geology and gas prospects are similar. We have completed an extensive seismic program and are planning to drill five to ten wells in 1978. The Company's net interest in this gas prone area will be around 7,500 acres when the earning work is completed. Because there will be a delay in marketing the gas, we plan to confine our expenditures to the minimum required to earn and maintain the lands.





Acadia-Haven

Paloma holds interest in 16,640 acres gross; 5,232 acres net in Acadia and Haven, near the eastern border of central Alberta. We now have interests in three gas wells, having participated in a recent Viking zone discovery at Haven. Gas marketing from this area is difficult but we expect to put one well on stream in late 1978. Additional drilling will be done, as gas marketing permits, on a number of indicated locations situated on our acreage.



Lait-Kilda

In these two areas along the southern border of Alberta, the Company has an interest in three gas wells. The Lait well was put on stream in early 1978 at around 300 MCFD marketed to Canadian-Montana Gas Company Limited. The two Kilda wells are still shut-in waiting a market. Our interest at Lait is 42.75% and our interest at Kilda is 26-39%, in a total of 6,905 acres.

Other Areas

In addition, some excellent gas discoveries were made during 1977 in the following areas:

Rowley

Gas was discovered in Viking and Mississippian zones and the well is currently shut-in waiting on market for the gas. Paloma has interests varying from 20 to 100% in six sections of land surrounding this east-central Alberta discovery.

Halliday and Wildunn

Also in east-central Alberta, our Halliday and Wildunn properties had gas discoveries in the Viking and Glauconitic zones. The Company has interests ranging from 5.52% to 46% in 5,280 acres in the area and we are continuing our exploration and acquisition of acreage.

Hercules

An excellent gas discovery in the Belly River formation was made on our lands at Hercules immediately southeast of Edmonton where we have interests ranging from 20% to 50% in 1,280 acres.

U.S.A.

Louisiana

Paloma Petroleums, Inc., our U.S. subsidiary, holds a 3.75% working interest plus a .94% overriding royalty on 22,000 acres located on the eastern and southern flanks of the Cotton Valley field which is located 35 miles northeast of Shreveport in Webster Parish, Louisiana. The first well, a farmout earning well drilled at no cost to us, discovered gas and gas condensate in the Smackover Grey Sand at 11,000'. This well also indicated hydrocarbons in the Justiss Sand of the Cotton Valley formation at 9,600' depth. The second well was drilled 300' from the first well to test the Justiss Sand and testing is still in progress on this well. The third well, drilled two miles north of the first two wells, found commercial oil (47° API) in the Justiss Sand and also found 60' of net gas pay in the Smackover in two Grey Sands. A fourth well is currently drilling midway between the first and third wells with the objective of testing the Justiss Oil Sand. Plans are being made to proceed concurrently with the development of the Cotton Valley Justiss Oil Sand and the gas bearing Smackover Grey Sand. Gas wells will be spaced on 640 acres per well and oil wells will be, initially, on 320 acre spacing. Both the oil and gas producing zones

have a history, in the area, of producing at a steady rate for many years. As no water has been found associated with our oil and gas pay zones, the areal extent of the reservoirs cannot be determined and we cannot predict the extent of the development program at this time.

Arkansas

In Arkansas, along the eastern extension of the Arkoma basin, we have a 33% interest in 106,000 acres. A number of gas fields lie on trend to the west of our lands; however, our lands have had very little drilling to date. A 5,000 ft. exploratory well drilled on our leases in 1976 was abandoned after finding gas in non-commercial quantities. Industry activity is increasing in this part of Arkansas and our group plans to seek a multi-well farmout of our holdings.

Oklahoma

We hold a 50% interest in 12,000 acres in the Arkoma basin of eastern Oklahoma. Geological evaluation has been done and we are attempting to have drilling done through a farmout.

HOTEL AND REAL ESTATE

The Company's subsidiary, Compass Investments of Alberta Ltd., owns and operates the Mayfair Hotel in Edmonton and has eight cafeterias located in Edmonton and Calgary. It also owns and leases out a small shopping centre in Drayton Valley and has property in Edmonton, Swan Hills and Smith, all located in Alberta.

Income from hotel operations, primarily from the 164 room Mayfair Hotel, was slightly less than in 1976, reflecting the sale of Swan Hills and Drayton Valley hotels; however, the shopping centre and cafeterias continued to produce excellent income.

The Company sold two Alberta hotels at Swan Hills and Drayton Valley during the year with some of the proceeds being invested in oil and gas projects and the balance likely to be utilized for the same purpose during 1978.

Property interests consist of a corner lot on Jasper Avenue, in Edmonton, 15 lots in the business section of Swan Hills and two and one-half acres in Smith.

December 31, 1977
(with comparative figures for 1976)

Assets

	1977	1976
Current assets:		
Cash	$ 1,158,909	$ 421,781
Accounts receivable	1,522,682	1,859,521
Marketable securities, at cost (market value 1976 — $1,049,064)	—	484,211
Inventories, at lower of cost or replacement cost	47,210	76,724
Prepaid expenses	26,978	16,554
Due from affiliated companies	124,000	—
Total current assets	2,879,779	2,858,791
Property, plant and equipment (Note 2)	20,895,523	18,403,993
Less accumulated depletion and depreciation	3,128,760	2,186,781
	17,766,763	16,217,212
Other assets:		
Agreements for sale receivable, net of current portion	81,988	127,277
Video tapes, at cost less amortization of $124,418 (1976 — $62,210)	311,049	373,259
Drilling and other deposits, at cost	68,496	70,996
Sundry	6,429	12,295
Financing costs, at cost less amortization of $43,204 (1976 — $21,602)	90,872	112,474
	558,834	696,301
Excess of purchase price of subsidiary over fair value of net assets acquired, at cost less amortization of $54,010 (1976 — $27,005)	756,153	783,158
	$21,961,529	$ 20,555,462

Liabilities

	1977	1976
Current liabilities:		
Accounts payable and accrued liabilities	**$ 553,166**	$ 1,629,533
Current portion of long-term debt (Note 3)	**2,519,029**	2,662,321
Total current liabilities	**3,072,195**	4,291,854
Long-term debt (Note 3)	**12,097,480**	11,606,851
Deferred income taxes	**2,309,415**	1,642,079
Minority interest in subsidiary companies	**336,721**	243,557
Shareholders' equity:		
Share capital (Note 4):		
Common shares without nominal or par value. Authorized 7,000,000 shares; issued 4,289,149 (1976 — 4,139,149)	**1,508,782**	1,171,282
Contributed surplus	**338,000**	338,000
Retained earnings	**2,298,936**	1,261,839
	4,145,718	2,771,121
	$21,961,529	$ 20,555,462

Approved on behalf of the Board:

C. Adams, Director

John E. Stobart, Director

See accompanying notes.

CONSOLIDATED STATEMENT OF EARNINGS

Year ended December 31, 1977
(with comparative figures for 1976)

	1977	1976
Revenue:		
Oil and gas	**$ 4,405,186**	$ 3,048,384
Hotel and real estate	**3,236,557**	3,422,570
Other	**89,059**	97,019
	7,730,802	6,567,973
Expenses:		
Oil and gas production	**669,675**	387,944
Mining properties surrendered	**165,675**	—
Hotel and real estate	**2,426,535**	2,719,198
General and administrative	**840,736**	617,513
Interest on long-term debt	**1,345,264**	1,493,701
Depletion	**658,986**	389,029
Depreciation	**322,770**	351,473
Amortization	**110,817**	110,817
	6,540,458	6,069,675
Earnings before income taxes, minority interest and extraordinary items	**1,190,344**	498,298
Income taxes:		
Current	**248,234**	191,556
Deferred	**582,309**	349,646
Province of Alberta Royalty Tax Credit	**(461,782)**	(346,967)
	368,761	194,235
Earnings before minority interest and extraordinary items	**821,583**	304,063
Minority interest in earnings of subsidiaries	**93,164**	19,998
Earnings before extraordinary items	**728,419**	284,065
Extraordinary items:		
Reduction of deferred income taxes resulting from application of drilling and exploration expenses by certain subsidiaries	**109,770**	149,500
Gain on sale of marketable securities, net of applicable income taxes in the amount of $152,946	**412,307**	—
Loss on sale of hotels, net of applicable income taxes in the amount of $194,797 (deferred — $85,027; current — $109,770)	**(213,399)**	—
	308,678	149,500
Net earnings	**$ 1,037,097**	$ 433,565
Earnings per share (Note 5):		
Before extraordinary items	**$ 0.17**	$ 0.07
Extraordinary items	**0.07**	0.03
	$ 0.24	$ 0.10

See accompanying notes.

CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION

PALOMA PETROLEUM LTD.

Year ended December 31, 1977
(with comparative figures for 1976)

	1977	1976
Source of funds:		
Earnings before extraordinary items	**$ 728,419**	$ 284,065
Add (deduct) items not affecting working capital:		
Depreciation	**322,770**	351,473
Depletion	**658,986**	389,029
Amortization	**110,817**	110,817
Deferred income taxes	**582,309**	349,646
Minority interest	**93,164**	19,998
Mining properties surrendered	**165,675**	—
Other	**—**	(3,871)
Working capital provided from operations	**2,662,140**	1,501,157
Gain on sale of marketable securities	**412,307**	—
Proceeds on sale of property, plant and equipment	**1,163,309**	201,492
Increase in long-term debt	**2,900,000**	1,665,000
Issue of share capital	**337,500**	—
Marketable securities reclassified as current	**—**	484,211
Reduction in agreements for sale receivable	**45,289**	44,747
Issue of 10% note payable	**—**	15,700
	7,520,545	3,912,307
Use of funds:		
Purchase of property, plant and equipment	**3,533,027**	2,908,465
Reduction of long-term debt	**2,409,371**	2,654,565
Financing costs	**—**	20,595
Purchase of additional shares in a subsidiary	**337,500**	25,000
	6,279,898	5,608,625
Increase (decrease) in working capital	**1,240,647**	(1,696,318)
Working capital (deficiency) at beginning of year	**(1,433,063)**	263,255
Working capital deficiency at end of year	**$ 192,416**	$ 1,433,063

See accompanying notes.

CONSOLIDATED STATEMENT OF RETAINED EARNINGS

Year ended December 31, 1977
(with comparative figures for 1976)

	1977	1976
Balance at beginning of year	**$ 1,261,839**	$ 828,274
Net earnings	**1,037,097**	433,565
Balance at end of year	**$ 2,298,936**	$ 1,261,839

See accompanying notes.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 1977

1. Accounting policies:

(a) The consolidated financial statements include the accounts of all wholly-owned subsidiaries, a 60%-owned subsidiary, Grenville Explorations Limited, and a 91.45%-owned subsidiary, Compass Investments of Alberta Limited. Compass Investments of Alberta Limited has a wholly-owned subsidiary Conquest Oil & Mining Ltd. which has a 80%-owned subsidiary, Compass Resources Ltd. During the year, Paloma Petroleum Ltd. acquired the remaining 20% of the outstanding shares of Compass Resources Ltd. for a consideration of $337,500 (Note 4).

(b) The Company follows the full cost method of accounting for exploration and development expenditures, wherein all costs related to the exploration for and development of petroleum and natural gas reserves are capitalized and depleted on the composite unit-of-production method, based on estimated proven reserves, as determined by independent engineers. Proceeds on minor property sales are credited to the net book value of property and equipment without recognizing any gain or loss on disposition. Gains or losses on major property sales are recognized in the statement of earnings.

(c) Oil and gas production and processing equipment is depreciated on the composite unit-of-production method. Other equipment is depreciated on the declining balance method at rates varying from 20-30 per cent which rates are estimated to amortize the costs over the useful lives of the assets. Depreciation has been provided on assets of the hotel and real estate operations on the straight-line method based on their useful lives as follows:

Building	4% - 5%
Equipment	5% - 10%

(d) Financing costs are being amortized on the straight-line method over a period of six years.

(e) The excess of purchase price of subsidiary over the fair value of net assets acquired at date of purchase, is being amortized on the straight-line method over a period of 30 years.

(f) Video tapes are being amortized over seven years using the straight-line method.

(g) The Company follows the tax allocation basis of accounting for all timing differences between net earnings and taxable income.

2. Property, plant and equipment, at cost:

	1977	1976
Oil and gas operations:		
Petroleum and natural gas properties	**$13,275,529**	$ 10,131,730
Less accumulated depletion	**2,079,990**	1,421,005
	11,195,539	8,710,725
Production and other equipment	**3,159,413**	2,444,261
Less accumulated depreciation	**658,755**	499,264
	2,500,658	1,944,997
Total oil and gas	**13,696,197**	10,655,722
Mining properties	**—**	165,675
Hotel and real estate operations:		
Land, buildings, equipment and improvements	**4,460,581**	5,662,327
Less accumulated depreciation	**390,015**	266,512
Total hotel and real estate	**4,070,566**	5,395,815
Total property, plant and equipment	**$17,766,763**	$ 16,217,212

3. Long-term debt:

	1977	1976
Bank loans	**$12,790,000**	$ 11,885,000
4% to 10% first mortgages and agreements for sale, secured by certain lands and buildings, due 1979 to 1988	**1,532,842**	1,803,226
10% note payable to shareholder including interest thereon, unsecured, subordinated in favor of bank loans	**—**	287,279
Note payable on video tapes, unsecured, non-interest bearing, due 1981	**293,667**	293,667
	14,616,509	14,269,172
Deduct current portion of long-term debt	**2,519,029**	2,662,321
	$12,097,480	$ 11,606,851

The bank loans are secured by an assignment of the Company's interest in certain petroleum and natural gas properties as well as guarantees to the bank by the parent and subsidiary companies. Interest is at the rate of 1½% over the prime lending rate.

Although the bank loans are payable on demand under the agreed terms of repayment, the following represents the estimated payments on the loan for the next five years:
1978 — $2,340,000; 1979 — $2,357,000; 1980 — $2,207,000; 1981 — $2,057,000; 1982 — $1,845,000.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

4. Share capital:

During the year, the Company issued 150,000 common shares in exchange for the shares owned by all the minority shareholders of a subsidiary company. The shares were issued for an aggregate consideration of $337,500.

5. Earnings per share:

Basic earnings per share is calculated using the weighted average number of shares outstanding during the year.

6. Remuneration:

The aggregate remuneration paid to directors and senior officers during the year amounted to $205,232 (1976 - $179,033).

7. Anti-Inflation Act:

The Company is subject to the provisions of the Anti-Inflation Act and Regulations governing the amount of dividend payments and as a result the amount of dividends which may be paid is restricted.

AUDITORS' REPORT TO THE SHAREHOLDERS

We have examined the consolidated balance sheet of Paloma Petroleum Ltd. as at December 31, 1977 and the consolidated statements of earnings, retained earnings and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the financial position of the company as at December 31, 1977 and the results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Calgary, Canada
March 7, 1978

Peat, Marwick, Mitchell & Co.
Chartered Accountants

PALOMA PETROLEUM LTD.

ANNUAL REPORT 1977

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PRINTED IN CANADA

Paloma Petroleum Ltd.

CONSOLIDATED STATEMENT OF EARNINGS
Six Months ended June 30, 1977
(with comparative figures for 1976)

	1977 (Unaudited)	1976 (Unaudited)
Revenue:		
Oil and gas	$1,962,340	$1,316,726
Hotel and real estate	1,763,630	1,706,027
Other income	40,315	48,926
	3,766,285	3,071,679
Expenses:		
Oil and gas production	224,145	145,828
Hotel and real estate	1,469,528	1,421,943
General and administrative	259,185	317,706
Interest on long-term debt	631,979	646,135
Depletion	276,607	149,568
Depreciation	177,593	164,690
Amortization	55,782	55,782
	3,094,819	2,901,652
Net earnings before undernoted items	671,466	170,027
Income Taxes:		
Current	231,000	114,000
Deferred	220,000	180,000
Province of Alberta Royalty Tax Credit	(228,000)	(175,000)
	223,000	119,000
Earnings before interest of minority shareholders and extraordinary items	448,466	51,027
Minority interest in earnings (losses) of subsidiaries	49,714	(12,852)
Earnings before extraordinary items	398,752	63,879
Reduction of deferred income taxes resulting from application of drilling and exploration expenses by certain subsidiaries	25,000	31,000
Gain on sale of marketable securities net of current income taxes of $164,250 and minority shareholders interest of $34,286	366,717	—
Net earnings	$ 790,469	$ 94,879
Net earnings per share:		
Before extraordinary items	$ .09	$ .01
Extraordinary items	.09	.01
	$ .18	$ .02

(Unaudited June 30, 1976 earnings have been revised in accordance with events reflected in December 31, 1976 audited earnings statement.)

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PRINTED IN CANADA

Interim Report

Six months ended June 30, 1977

PALOMA PETROLEUM LTD.

PALOMA PETROLEUM LTD.

to the Shareholders:

Paloma Petroleum Ltd. increased its oil and gas revenues by 49% during the first half of 1977 over the corresponding period of 1976. Hotel and real estate income remained relatively constant.

Financial highlights for the six months ended June 30, 1977 are as follows:

	1977	1976
Gross income	$3,766,285	$3,071,679
Cash flow from operations	1,212,734	601,067
Per share	.28	.14
Net earnings before extraordinary items	398,752	63,879
Per share	.09	.01
Net earnings	790,469	94,879
Per share	.18	.02

Gross natural gas production increased 17% to 2,024 MMCF compared to 1,724 MMCF for the first six months of 1976. Crude oil and condensate production increased 2% to 76,087 barrels compared to 74,855 barrels for the same period in 1976. The increase in gas production has been less than expected due to the current weak gas market in Alberta and, more particularly, to pipeline problems affecting the Dunvegan field, our major source of revenue. The pipeline problems are now believed to be overcome. Although weak gas markets continue we fortunately have most of our gas production under "take or pay" contracts.

Paloma's drilling results for the first six months are:

	Gross	Net
Wells Drilled	18	5.3
Gas	12	3.7
Oil	1	0.8
Dry	5	0.8

The Company has an 80% working interest in a new oil well completed near the Leduc field in Alberta, which is producing steadily at 170 barrels per day.

New gas production went on stream at Stanmore, Alberta, where the Company has been actively developing a field. We are pleased to report that 10 gas wells have been drilled at Stanmore to date and further drilling is planned. Most of the wells tested at rates from 1 - 4 MMCF per day and we expect to be selling in excess of 6 MMCF per day by fall, 1977. The Company's average working interest at Stanmore is 40%.

At Rowley, Alberta, Paloma has a 40% interest in a gas condensate discovery and owns 2,304 net acres in six sections around the discovery. Further developments are awaiting a market for the gas.

Additional Alberta gas wells were drilled in other areas as follows:

Belloy	2 wells
Dorenlee	1 well
Dunvegan	1 well
Jarrow	2 wells
Nestow	1 well
Sedalia	2 wells
Wainwright	1 well

In the U.S., Paloma participated in a gas condensate discovery in Webster Parish, Louisiana. Production comes from multiple Jurassic sands at 9 - 10,000′ depth. The deepest producing zone tested 1.9 MMCFD and the higher zones are being tested in a second well. A third well is planned to be drilled immediately. The Company has a working interest of 3.75% plus a 0.94% gross override in 19,000 acres around the discovery.

The Company's hotel property at Drayton Valley, Alberta was sold in July for $575,000. The net proceeds from this sale will be invested in oil and gas operations.

John E. Stobart

August 31, 1977
Calgary, Alberta

John E. Stobart
President

Paloma Petroleum Ltd.

CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION

Six months ended June 30, 1977
(with comparative figures for 1976)

	1977 (Unaudited)	1976 (Unaudited)
Source of funds:		
Net earnings before extraordinary items	$ 398,752	$ 63,879
Add (deduct) items not affecting working capital:		
Depreciation	177,593	164,690
Depletion	276,607	149,568
Amortization	55,782	55,782
Deferred income taxes	220,000	180,000
Minority interest	84,000	(12,852)
Working capital provided from operations	1,212,734	601,067
Gain on sale of marketable securities	366,717	—
Increase in bank loans	1,100,000	500,000
Reduction in agreement for sale receivable	20,563	—
Issue of 150,000 shares in exchange for all of minority shares of a subsidiary	337,500	—
Proceeds from sale of property, plant and equipment	—	302,405
Other assets	(7,264)	18,105
Total working capital provided	3,030,250	1,421,577
Use of funds:		
Purchase of property, plant and equipment	1,578,976	1,530,706
Reduction of long-term debt, including amounts reclassified as current	1,323,985	992,526
Financing costs	—	20,595
	2,902,961	2,543,827
Increase (decrease) in working capital	127,289	(1,122,250)
Working capital (deficiency) at beginning of period	(1,433,063)	263,255
Working capital (deficiency) at end of period	$(1,305,774)	$ (858,995)